Privacy and Tax Evading

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Yoseph M. Edrey Di 26 Apr 2016

Let me begin with a blunt – actually provocative – statement: Privacy is the shield of the villains.

Honest and sincere people don't have any information they need to conceal. In an idealistic society, men and women should not be afraid of stepping out of the closet, or hide their background, race, religion, emotions, and feelings. Why shouldn't we live according to our own believes and inclinations and take responsibility for our own actions? And if something is deeply wrong with our personal inclinations, shouldn't it be better for us and for our communities to get rid of them, to get emotional or medical treatment or at least warn our neighbors if we could be a danger to them or their children? And if they are not dangerous or wrong, shouldn't we be proud of them instead of being ashamed, frustrated or miserable?

On the economic level: confidentiality and secrecy create, by definition, a market failure – asymmetric information. Why is it so crucial to conceal any aspect of our income? Just consider a simple scenario where a candidate employee is interviewed by the employer. The candidate is supposed to provide all the details about her economic situation, including lifestyle, health, income and wealth. The employer is not under any kind of such obligation. Wouldn't it be wonderful if both sides get every piece of relevant information including the employer's income? Such negotiation will certainly produce the most efficient employment contract; no surprises, disappointments, abuse or exploitation.

Some 60 years ago, while questioning the reasons for the Israeli income tax system for adopting the British Scheduler Income Tax doctrine, Prof. Lapidoth raised the possibility that this doctrine was intended to maintain the social gaps in England: The upper class taxpayers reported their income to "common" assessment officers. In order to prevent the public from receiving and accumulating too much information about the true magnitude of the upper class's wealth, the taxpayers reported their income from different sources to different assessment officers. In the name of privacy, the officers were forbidden to exchange information and this achieved industrial and social tranquility.

If the public is not aware of its misfortunate situation, it won't resist. As a series of economists – which are referred below as "worldly philosophers" (such as George Stigler and Jean Tirole among others) have suggested, if I may be blunt again, that the public stands a very small chances against powerful and dominant firms, which have a wicked tendency to integrate vertically and to increase their control. Furthermore, there is a constant danger that lazy, or God forbid crooked, government officials (including legislators who rely heavily on fundraising) will get "captured" by the same businesses they are supposed to regulate and supervise, and due to various "human" reasons (i.e.: greed) fail to fulfil their duties.

Before discussing economics, a caveat: In general terms, there are two types of economists. In his "Worldly Philosophers" Robert Heilbroner illustrates how the science of economics has been changed during the last two and a half centuries. We tend to forget that those who created the science of economics – like John Locke, Adam Smith, John S. Mill and others – were first and above all philosophers, who dealt with ethics, values, general welfare and social justice. Gradually the gaps between economists and philosophers began to grow. Instead of dealing with welfare and wellbeing, the common economists (mainly American and a few European) had turned their interest to a technical/mathematical science that focuses on mechanical measurements of short-run economic growth, profits and business' success. Such tendency became prevalent during the 20th century. It concentrates mainly on shortsighted earnings. Consideration of long lasting efficiency and the society's welfare were replaced by profit maximization and business success. Market economy was confused with "business economy"; the invisible hand was replaced with capitalism, which deviates from free market economy and instead provides special privileges to capital owners. The discontent from this new tendency is very well expressed by the Nobel laureate Joseph Stigliz's note: "creating market value had become entirely separated from creating employment." Hence, while referring to non-technical economist we use here Heilbroner's term, i.e. “worldly philosophers”.

Prominent worldly philosophers have expressed a great deal of concern regarding the new trend of business economy. Alfred Marshall, Arthur Pigou, Thorstein Veblen, Mancur L. Olson Jr., Gary Becker, Kenneth Arrow, John Galbraith, Robert Heilbroner, Robert Solow, Arthur Okun, Amartya Sen, William Vickrey, Joseph Stiglitz, Paul Krugman, Thomas Piketty, Jean Tirole, George Akerlof, Robert Shiller and even Luigi Zingales, among others, are very much concerned with social gaps, general welfare, economic inequality, income distribution, capital accumulation and concentration that infringe free market and economic efficiency in its broader sense, in addition to the constant threat to democracy caused by small and cohesive groups, who manage to gain privileges from the policy makers.

The French economist Thomas Piketty bases his research and conclusions on large and extensive historical and comparative data, which was unavailable for previous researchers; data covering three centuries and more than twenty countries. In his book *Capital in the Twenty First Century,* he expresses a great deal of concern regarding the widening of social gaps, which, according to his findings, will continue unless the governments or the international democracies take some drastic measures. The underlying rationale for Piketty’s argument is direct, rational and convincing. “When the rate of return on [financial] capital exceeds the rate of growth of output and income [i.e. the average rate of return of the combined return on human capital and financial capital], capitalism automatically generates arbitrary and unsustainable inequality that radically undermines the meritocratic values on which democratic societies are based”. In a simple formula: when returns on capital (r) grows faster than the economy (g), i.e. “r>g”, the return to financial capital is greater than the return to labor. In other words, income from capital and wealth, and not earnings from labor, dominates the income distribution in our society.

As it has become quite clear lately, unfair tax systems – de jure or de facto – enhance social gaps, harm the economic efficiency, erode the social solidarity and undermine the structure of the society. International tax planning raises its own problems as long as its purpose is to produce double non-taxation, which undercuts Reuven Avi-Yonah’s “single tax” principle, up to the level that creates a huge capital formation in the hands of very few people, which endanger the backbone of democratic societies.

Some leading worldly philosophers (such as Atkinson, Stiglitz, Piketty, Ostry and others) have published lately some **empirical data**, indicating the inefficiency of social gaps, poverty and inequality.

Ostry et al. from the IMF, published a “**Staff Discussion Note“,** which contains fascinating findings, based on empirical evidence – mainly the World Income Inequality Database. The Note concludes that social gaps are significant factors for lower economic growth; “Inequality can undermine progress in health and education, causes investment-reducing political and economic instability, and undercuts the social consensus required to adjust in the face of economic and social shocks, and thus it tends to reduce the pace and durability of growth”.

The Note defies the possible claim that inequality may impede growth at least in part *because* it calls forth efforts to redistribute, which themselves undercut growth. Based on a compiled cross-country dataset that distinguishes **market** inequality (before taxes and transfers) from **net** inequality (after taxes and transfers), allows the researchers to calculate redistributive transfers for a large number of country-year observations. Their main findings are as follows: First, more unequal societies tend to redistribute more. Second, lower net inequality is robustly correlated with faster and more durable growth. And third, redistribution appears generally benign in terms of its impact on growth; only in extreme cases there is some evidence that it may have direct negative effects on growth. Thus, the combined direct and indirect effects of redistribution are on average pro-growth. Hence, the common conclusion that there is a big tradeoff between redistribution and growth is probably unfounded.

These are fascinating developments, in what I consider as the first chapter of the first scene of the social-economic revolution (actually I prefer the term evolution) the Western world is facing in the coming future. A vivid proof of the evolution is the unprecedented support of young and very much enthusiastic voters for the Democratic Party presidential primaries provided to an old politician who refers to himself as a socialist in these very days in the U.S..

It seems to me that the Western world is approaching a new era, which will eventually replace the old one. The interested and powerful group will be no longer able to manipulate (shall I use the terrible phrase brainwash?) the public with false but sophisticated insights about the tradeoff between efficiency and equality; about the “trickle down economy”.

The main reason for the end of this era is computers and the internet. All of a sudden a flood of information reaches the public with no biased intermediaries involved. Worldly philosophers reach out an unlimited amount of readers and the ideas of “trickle up economy”, „Of the *1%*, by the *1%*, for the *1%”* and “supersalaries” have become accessible not only to scholars and students but to tens of millions users of the internet, in their own language! Marshall McLuhan’s vision (or rather prophecy) has become a reality.

The Panama Papers are just an additional nail in the old social economic system’s coffin. The public should suspect that if its leaders (political or economic) hide their money in tax havens, away from the public’s eyes, maybe he or she possesses information that should be shared with everybody: either your country’s economic system is fragile or weak, or the requirement to pay taxes as the price for the public goods and services is aimed only for suckers.

Let me go back to my opening blunt statement. The right of privacy is the villains’ shield. No doubt it is too swift. It deserves some modification. But it should be the general insight. The legal or constitutional issue should not focus on preventing the flow of information but rather on **the way the informed uses the information.**

Back to Taxes. It is noteworthy that the Israeli Income Tax Ordinance contains the following article:

1. (a) The Minister of Finance may publish a list of all taxpayers, which shall include the amount of taxable income of each of them, for a particular tax year, as was reported in their annual tax return, or as determined by the tax assessor or by a Court, as the case may be. If there is a change in the list in question – due to an objection or an appeal filed by the taxpayer – the list will be amended at the request of the taxpayer accordingly; any person is entitled, at times and places prescribed, to review the list published and to receive a certified copy, in return for a fee prescribed.

None of the Israeli Minister of Finance ever exercised this authorization. When I attract my students’ attention to that provision, the reaction is almost always the same: A slight repulsion and disbelief. Only very few approach me after a few meetings and admit that they can’t explain their immediate reaction, and that the idea is not as bad as it sounded at first.

No doubt, it is a matter of culture and education. When economics professors teach the concept of deadweight loss, some of them tend not to mention that the value of the publics’ goods and services, which are provided by taxes, are probably higher than this loss. Hence the impression the students receive is that taxes reduce, by definition, the taxpayer’s welfare or utility. Hence, no wonder the general belief is that taxes are a mandatory payment where the payer does not receive a quid pro quo from the elected government. A careful analysis provides a different concept. Taxes are not a mandatory payment. As long as taxes maintain and follow the “canons of good tax” they are paid with consent. The public, through its agents, supervises and approves the price of the publics’ goods and services annually, by the approval of the annual national budget and every four years by electing the public agents.

A careful understanding of Locke’s “labor justification” of property rights reveals that all members of an income production process are entitled to their share in the produced income according to their own input, the use of their factors of production. During the last decades a new insight has been developed. There are three factors of production, not two: real capital, human capital and **social capital**. All the members of the “Joint project” that produces income contribute their factors of production; the workers, the capital investors and the public. The public invests social capital in the community’s infrastructure; in providing functioning and secured markets, law and order, freedom of occupation and trade, and other public goods and services that enable firms to produce wealth and income. As the owner of the social capital, the public receives its share through taxes. In other words, a good tax system is nothing but a **profit sharing mechanism** between the owners of all **three** factors of production.

Those taxpayers who try to evade their duty to honestly split their profits with their partners are nothing but free riders. The Panama papers help the public reinstate the profit sharing mechanism, and restore its ability to confirm that those free riders won't be able to abuse their privacy "right" and avoid paying their fair share to the governments for using public capital.

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